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SUBJECT: Honduran Government Paper on Agricultural Finance Reform

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¶1. As indicated in reftel, on June 30 the Finance Minister provided to Econcouns a 32-page analysis entitled "Honduran Agriculture Laws," intended to answer IMF and USG questions on the rationale behind the April 2003 passage of Law 68-
¶2003. The document was prepared by the Finance Ministry together with Honduran Banking Commission President Ana Cristina de Pereira. This cable provides a detailed English language summary of the paper. The full Spanish language version has been faxed to WHA/CEN (Brett Makens). The paper makes the case that the government did the best it could, within legal strictures, to limit and manage the fiscal cost of a series of imprudent agricultural finance laws. The paper also clarifies that the previous agricultural support programs, replaced by Law 68-2003, were already being implemented and having a significant effect on GOH finances. Finally, the paper clarifies that the GOH understands that resumption of credit to the agriculture sector will be a slow process (given the moral hazard problems created by these various loan forgiveness programs).

Begin Detailed English Language Summary.

HONDURAN AGRICULTURAL LAWS

INTRODUCTION

Several laws that provided financial support to the agriculture sector were adopted by the GOH between 2000 and
¶2003. The objectives of these laws was to reactivate agricultural production, severely affected by the impact of Hurricane Mitch in late 1998 on the value of agricultural assets, the capacity of the sector to generate employment and income, and on the supply of exportable products. Damages from Hurricane Mitch in Honduras have been estimated by ECLAC at $2.6 billion (principally agricultural production and road and bridge infrastructure).

Government assistance to farmers in these years rested on the assumption that the reactivation of agricultural production could be achieved by partially resolving the financial problems faced by farmers. The measures taken by the government in this period included interest rate subsidies and forgiveness of some agricultural debt. The implementation of these measures, however, had two important negative effects that doomed the laws to failure:

1) An increase in debt levels resulting from the accumulation of interest payments that were capitalized into each loan. This lowered the profitability of new investment projects.

2) Each of these laws failed to achieve its expected goals and consequently increased the social and political pressure for new measures containing additional benefits, raising the fiscal cost, increasing the moral hazard, and perpetuating the problem instead of resolving it.

At the same time, the debt reduction, interest rate subsidy and new credit programs provided to farmers involved high costs for the GOH. Previously, the schemes were expanded in order to augment partial payments made by the GOH to the financial institutions on behalf of farmers, thus reducing the levels of debt (partial forgiveness of the principal). This last benefit was financed through the issuance of government bonds, sold on market terms.

Given that the conditions of debt restructuring implied repayment schedules with long grace periods, the farmers could manage the interest payments during the grace period, helped by the interest rate subsidy financed by the government. Nonetheless, the lack of viability of the mechanisms was made evident when the repayment schedule required the amortization of the principal.

The lack of a definitive solution caused increasing fiscal

commitments without achieving the desired result. It also hurt the functioning of credit markets; in particular, bank credit for the agricultural sector declined in real terms. The agricultural sector's rate of growth and contribution to GDP has been declining steadily, with a consequent negative effect on the social situation. Poverty in Honduras is concentrated in rural areas.
Additionally, the Honduran financial system has suffered a worsening of the arrears in the credit portfolio and a reduction in the profitability of financial institutions, because of the increase of the nonproductive assets (bad debts and repossessed rural properties) as well as the lack of dynamism of new investment projects in the sector.

Recognizing the need to resolve the problem in all its dimensions, the GOH has designed a new policy proposal that not only seeks to resolve in a definitive form the problem of the accumulated debt levels of farmers, but also to establish new rules of the game for participants in agricultural credit markets, trying to return discipline to the market and limiting the fiscal cost associated with the implementation of the new mechanism.

THE CONTENT OF THE PREVIOUS AGRICULTURAL FINANCE LAWS

Law 28-2000

Law 28-2000 entered into effect on April 28, 2000. It created a framework for the alleviation of the financial burden on farmers who were affected by natural phenomena and had loans in arrears. The benefits were made available to borrowers with loans approved between June 1997 and January 2000, either with resources from FONAPROVI or private banks.

It established a fixed interest rate of 24 percent for direct bank loans and 19 percent for loans from FONAPROVI provided for the production of basic grains, vegetables, plantains, watermelon, and tubers and 24 percent for the remaining types of production. Interest rate subsidies varied from 8-16 percentage points for loans in these categories and cattle projects, and 2 percentage points for other types of agricultural production.

In addition, Law 28-2000 directed the government to provide loan guarantees from resources of the National Complementary Guarantee Fund (FONGAC) - a fund administered by FONAPROVI with resources transferred by the Ministry of Finance - for up to 70 percent of the amount of new loans provided by financial institutions for the rehabilitation of farms.

Decree 28-2000 did not establish specific terms for the restructuring of farm debts. But the PRODUCOM program, which functioned like a trust fund of the Ministry of Finance in FONAPROVI, authorized up to seven years with 18 months' grace period for the payment of rescheduled loans.

The law also approved transfers to the state-owned National Bank of Agricultural Development (BANADESA) for 115 million lempiras, of which 15 million were to be used for the program of supervised credit, which channels small loans to the reformed campesino (organized small farmer) sector.

Law 32-2001

Law 32-2001 established the legal framework to authorize interest rate subsidies and reductions in the debt balance owed by farmers affected by natural phenomena, who had taken out loans for agriculture, forestry, cattle, beekeeping, poultry, aquaculture, fishing, agriculture mechanization services, irrigation, grain drying, or salt extraction.

Loans approved after June 31, 2000 and beneficiaries of Law 28-2000 were designated as eligible for the benefits of this law. It provided interest rate subsidies ranged from 7 to 16 percentage points for basic grains, vegetables, plantains, watermelon, tubers, cattle, and coffee and two percent for other types of crops.

The law established a maximum amount for loan rescheduling of 4 million lempiras per borrower. It also established a reduction in the capital balance for beneficiaries in one of the three following situations:

1) Direct credits by banks, FONAPROVI loans, or other rediscounting sources, and savings and loan cooperatives, affected by natural phenomena and in arrears or due on December 31, 2000 and classified as loan risk category III or IV;

2) Beneficiaries of Law 28-2000, and
3) Borrowers from savings and loan cooperatives, under the same circumstances.

Debt reduction of 50 percent was provided, up to a maximum level of debt forgiveness per borrower of five million lempiras.

The law required the banks to provide new loans for the rehabilitation of farms, unless the farmers decided to forgo this financing in writing. The farmer had to pay the interest owed, from January 1, 2001 through the date of presentation of the application.

Of the 50 percent of debt relief, ten percent was financed by the banks and 40 percent by the GOH, through the issuance of 10-year bonds, with interest rates equivalent to the average deposit rate. The law authorized up to 600 million lempiras in government bond issuance.

Two additional mechanisms were established:

1) For original loan balances of 300,000 lempiras and more that had financed production of basic grains in areas of 50 manzanas or less, the law provided debt forgiveness of 40 percent immediately. An interest rate subsidy of five percentage points was authorized for the remaining loan balance.

2) For loans by small producers of basic grains with loan balances of 50,000 lempira or less classified in loan risk categories III and IV, full debt forgiveness (90 percent paid by GOH and 10 percent by the banks) was provided. Loans classified as risk category V were to be bought by the Ministry of Finance with a discount of 80 percent.

The GOH transferred the 115 million lempiras to BANADESA, as directed in Law 28-2000, and forgave the debt that BANADESA owed to the GOH.

The law established an interest rate subsidy of 8 percent for growers of basic grains, to be paid with Central Government funds, independently of whether a guarantee was received from FONGAC.

Law 128-2001

Law 128-2001 modified various articles of law 32-2001. It allowed benefits to accrue from the moment that the farmer signed the contract with a financial institution. It also expanded the coverage to farmers who had received a loan before July 31, 2001, in order to pay a previous loan that had qualified for benefits under law 32-2001, and the borrowers from banks declared in forced liquidation.

Law 128-2001 created the option of raising the ceiling for debt forgiveness from 5 million to 10 million lempiras in those cases in which there had been destruction of the productive asset.

Law 81-2001

Law 81-2001 approved the issuance of bonds by FONAPROVI of up to 1.2 billion lempiras at terms of 18 months, 10 years and 15 years in order to create lines of credit for working capital, capital goods and rediscounting of up to 70 percent the restructured credits in the previous three laws. To qualify, the loans needed to be used for reactivation and rehabilitation of the agriculture sector. The law provided interest rate subsidies of between four and eleven percentage points.

Law 11-2002-E

Law 11-2002-E added to the beneficiaries of the interest rate subsidies in 81-2002 the following products: machinery, equipment and parts; harvesting of pasture; construction; planting; acquisition of livestock and poultry; and production of rhyzomes. It extended the deadline for application of benefits to December 31, 2003.

ESTIMATES OF THE COSTS OF THE PREVIOUS DECREES

Interest Rate Subsidies
The loans that have been covered by interest rate subsidy under the different decrees:

Decree 28-2000	L 1,417.1 million
Decree 32-2001	L 2,097.9 million
Decree 81-2002	L 848.7 million
Total	L 4,363.7 million

During 2000-2002, 195.8 million lempiras in interest rate subsidies were provided. These amounts were provided to farmers as reimbursements for interest payments already made; these reimbursements were deducted from the value of the trust fund. In Decree 128-2001, the system was changed. After that, the farmer only paid the interest net of the subsidy, and FONAPROVI credited the account of the financial institution directly. This broke the link between farmer compliance with payment obligations and the authorization of the GOH to continue authorizing subsidies.

The total amount of interest subsidies authorized by the five previous laws was: L 1,494.4 million, of which L 195.8 million was paid out during 2000-2003.

Debt Forgiveness

Estimates of costs incurred through the authorization of debt forgiveness (as of May 31, 2003) are:

Total bond issue authorized	L 600 million
Total bonds issued	L 274.1 million

One large bank, Banco Atlantida, received L 101.2 million in bonds (slightly above the 99.4 million authorized as a result of errors in program management). All other banks are far under their limits.

Guarantees

The National Fund of Complementary Guarantees (FONGAC) has issued certificates to guarantee the payment of balances owed by farmers benefiting from the different laws. After taking into account the deductions from the value of the trust fund for subsidy payments, there was a legal limit of issuance of L465 million in guarantees. Of this amount, 306 million were issued as of December 31, 2002 and another L 175.7 million were authorized. FONGAC's financial capacity to guarantee new loans thus has been totally exhausted. To comply with the obligations for loan guarantees in the laws, the Central Government would need to make additional transfers to FONAPROVI. The GOH estimates that this contingent liability is L2.5 billion lempiras.

The total committed fiscal resources (estimated at the end of May 2003) over the period 2000-2019 is 2.9 billion lempira, with another 2.5 billion lempira in contingent liabilities for the loan guarantees.

THE PROPOSED NEW POLICY

The policy framework designed to resolve these earlier problems is based in the following assumptions:

¶1. Lending to the agricultural sector is affected negatively by structural problems. Credit risk does not depend on the capacity to pay of an individual but on generalized market risks such as climatic conditions, or the international price of an export crop like coffee.

¶2. Social and political pressures have resulted in misguided policies focused on the reduction of debt levels instead of the search for income-generating alternatives. The attempt at debt reduction was not successful because it did not materialize immediately and the system permitted the capitalization of interest, with the result that debt levels actually increased.

¶3. The benefits have worsened the country's payment culture and degraded the quality of risk posed by the banks' agricultural clients.

¶4. The debt burden represents a tax on the profitability of future investments in the agricultural sector that provides disincentives to the renewal of agricultural activity.
¶5. The lack of investment is reducing the supply of agricultural production, which in turn negatively affects employment, income and the social situation in rural areas.

The new framework is contained in Law 68-2003. It creates a financial mechanism to distribute losses and generate conditions that will spur growth in the agricultural sector. It supercedes all the previous laws and establishes a mechanism that treats all beneficiaries of the program uniformly.

Law 68-2003 establishes a government trust fund, financed through annual transfers from the Central Government budget, of decreasing amounts, starting in 2003 and ending in 2012. The trust fund will have the ability to issue securities for:

-- Acquisition of the portfolios restructured under decrees 28-2000, 32-2001, 128-2001, 81-2002, and 11-2002-E. The trust fund will provide debt reduction of 50 percent of the balance on the loan at the moment of its acquisition and will enter into contracts with the financial institutions for the recovery of the remaining 50 percent. This will be done with a payment plan over 10 years and an interest rate of 8.725 percent.

-- Payment of the net present value of the interest rate subsidies for rehabilitation and reactivation, authorized under the mentioned laws. The GOH will use a discount rate of 8.725 percent to calculate the net present value. The borrowers will need to pay the remaining balance of their loans, using the original terms.

The law authorizes issuance of government bonds up to a maximum of 4 billion lempiras (with the bulk of the funds to be used for the purchase of the portfolio accounts rescheduled by financial institutions). The interest rate to be paid on the bonds is 5 percent. The bonds will be issued for a ten-year period, with annual amortization that will be guaranteed (for 50 percent) by the financial institutions. The remaining 50 percent will be guaranteed with the amounts paid by the GOH through annual transfers:

Year	Millions of Lempira
2003	347.3
2004	322.0
2005	241.5
2006	198.6
2007	173.6
2008	123.5
2009	93.6
2010	77.7
2011	63.8
2012	51.8
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Total	1,693.4

Through the investment of the resources received annually, FONAPROVI (the National Fund for Production and Housing) will generate the necessary resources to cover the interest and principal payments. Thus, the sum of the GOH contributions will be lower than the guaranteed amount.

The law repeals the guarantees authorized by the GOH in the previous laws for the financial institutions, for rescheduled loans and for reactivation and rehabilitation loans, including the certificates that had been issued by FONGAC.

The decree establishes, in addition, conditions for new credits by financial institutions that will be rediscounted with FONAPROVI funds:

a) detailed technical and financial evaluation of the loan
b) crop insurance (covering risks like natural disasters)
c) contracted marketing mechanism
d) sufficient guarantees

The law also allows financial institutions to arrange insurance or guarantees against price declines, for those loans that finance agricultural exports outside of Central America. Embassy Note: These risk reduction mechanisms were strongly encouraged by the authors of the IMF-World Bank Financial Sector Appraisal (FSAP) for Honduras, completed earlier this year. End Note

The law ratified the creation of the Fund for the Small Producer, through GOH transfers to BANADESA (L140 million in 2003, 130 million in 2004, and 130 million in 2005).

The tables below provide the government's estimates of the costs implicit in the earlier regime and the new one:

Financial Costs of Previous Scheme
(millions of lempira)

	Nominal	Present Value
Int. Rate Subsidies	1,494	1,121
Interest costs of bonds	363	230
Transfers to BANADESA	575	340
Recap.of FONGAC	482	482
Bond for debt relief	--	298
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	2,914	2,470

Financial Costs of Current Scheme
(millions of lempira)

	Nominal	Present Value
Transfers to trust	1,693	1,386
Interest costs of bonds	166	129
Transfers to BANADESA	575	340
Int.subsidies paid	196	
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	2,630	1,856

RESTRICTIONS ON THE DESIGN OF THE POLICY FRAMEWORK

The GOH confronted limitations in trying to design the optimal solution to the problem.

First, the repeal of the laws does not eliminate the rights authorized to the borrowers which were beneficiaries of each law at the time they took effect. The majority of the beneficiaries already had received payments.

All the legal consultations undertaken by the government concluded that it was impossible to apply a new legal framework retroactively. This meant that even when the laws were repealed, the only gain was that new farmers could not benefit from these laws after the date of the repeal entering into force.

For this reason, the government had to look for a financial mechanism that simultaneously applied the same level of fiscal resources already committed and still permitted the reduction of future contingencies, effecting an efficient distribution of the economic losses already incurred and help the farmers reactivate their operations.

The second important restriction is the existence of deposit insurance in Honduras, which guarantees 100 percent of the deposits by the public in financial institutions that are members of the deposit insurance, until September 2003. After this point, the insurance will be limited to 50 percent and later to USD 10,000 per depositor after September 2004.

Thus, if the government were to have shifted totally the losses of the agricultural sector to the financial system, it would have led to an immediate recognition of the losses by these financial institutions. This would have occurred in the context of a fragile financial sector with a limited capacity to generate profits and an ongoing process of financial sector consolidation. The Government of Honduras did not consider it in its interest nor its financial capacity to undertake these risks.

RECENT EVOLUTION OF THE AGRICULTURAL SECTOR

The amount of agricultural loans covered by the various previous laws represented 7.7 percent of the total loan portfolio of Honduran commercial banks and 44.6 percent of the agricultural loan portfolio (as of Febrary 28, 2003). The continual issuance of decrees during the grace periods of the loans kept these loans in low category classification, with low provisioning requirements, given that they still had not arrived at a period of amortization of the principal. Only 4.3 percent of these refinanced credits were provisioned as of January 31, meaning that the losses came directly out of bank profits or capital during those periods, without eliminating the acquired rights by the borrowers.

The mechanism created by Law 68-2003 permits financial institutions to gradually absorb the impact of their respective losses.

New credit provided to the agricultural sector annually has fallen precipitously. These declines were 5.9 percent in 1999 and then 15.8 percent, 22.1 pecent, and 51.4 percent in 2000, 2001, and 2002. New agricultural loans represented only 4.1 percent of the total credit issued by the banking system in 2002, down from 8.3 percent in 1998. The decline in agricultural finance is one of the factors contributing the stagnation of agricultural production.

Given the recent experience of the commercial banks with agricultural loans, no important reactivation of credit for this sector is expected in the next few years. The introduction of new rules for the approval of agricultural credit will instead be the source of a process of natural selection of debtors and a channeling of credit through suppliers like agrochemical firms, agricultural service providers, concentrate factories, and agricultural processing firms.

In the experience of other countries that have had similar problems, the change in the sources of credit for the agricultural sector have served to restore a payment culture and improve the administration of credit risk in the formal financial sector.

In addition, this new situation implies the search for alternatives on the part of the GOH for the channeling of credit to the small producer, through the contracting of specialized technical assistance and within the framework of bank consolidation.

End Detailed English Language Summary.

Palmer